

***United States Court of Appeals  
for the Second Circuit***



**BRIEF FOR  
APPELLANT**



77-6117

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**United States Court of Appeals**  
FOR THE SECOND CIRCUIT

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MEDITERRANEAN REFINING COMPANY,

*Plaintiff-Appellant,*

—against—

THE UNITED STATES OF AMERICA,

*Defendant-Appellee.*

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ON APPEAL FROM THE UNITED STATES DISTRICT COURT  
FOR THE SOUTHERN DISTRICT OF NEW YORK

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**BRIEF FOR PLAINTIFF-APPELLANT**

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## BRIEF FOR PLAINTIFF-APPELLANT

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### Preliminary Statement

This is an appeal from a Memorandum Decision of J. Tenney dated May 26, 1977 (Number 45958), granting defendant-appellee's Motion for Summary Judgment and denying Plaintiff-Appellant's Motion to Transfer to the Suspense Docket.

### Issue Presented for Review

Whether Plaintiff-Appellant has accrued the 1962 Lebanese Income Tax Assessment for purposes of bringing suit within the 10 year statute of limitation period prescribed by I.R.C. §6511(d)(3).



### Statement of Facts

Mediterranean Refining Company, a Delaware Corporation, entered into a Convention with the Lebanese Government (Law of December 18, 1945) whereby in consideration of the promise to build an oil refinery in Sidon, Lebanon, said company, pursuant to Article X of said Convention was granted immunity from taxation. After the refinery was completed and went on stream, the Lebanese Parliament on June 29, 1956 promulgated a law which nullified said company's immunity from taxation.

Pursuant to the June 29 law, assessments were made on the income of Mediterranean Refining Company by the Lebanese tax authorities including the 1962 tax assessment which forms the basis of Plaintiff-Appellant's suit for refund.

Plaintiff-Appellant has resisted paying such assessments. Negotiations were interrupted in 1973 due to the political circumstances in Lebanon and to date have not been resumed (see Answer to Interrogatories, No. 1(c)).

Plaintiff-Appellant contends that it is entitled to a credit against U.S. income taxes paid for the year 1962 in the amount of the Lebanese tax assessment for that year and filed this suit for refund within the 10 year period prescribed in I.R.C. §6511(d)(3).

### ARGUMENT

**For purposes of I.R.C. §6511(d)(3) and under the holding of Revenue Ruling 58-55, Plaintiff-Appellant has accrued a Lebanese tax duly assessed under authority of law.**

1. The issue presented concerns the meaning to be given to the term "accrued" as used in I.R.C. §6511(d)(3):

"If the claim for credit or refund relates to an overpayment attributable to any taxes *paid or accrued* to any foreign country . . . the period shall be 10 years from the date prescribed by law for filing the return for the year with respect to which the claim is made."  
(Emphasis added)

2. The term "accrued" is essentially an accounting concept and in normal usage for income tax purposes is covered by Treas. Reg. §1.461-1(a)(2) providing in part:

"Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy."

The accrual method of accounting is contrasted with the cash receipts and disbursements method.

3. Under the rationale of *Dixie Pine Products Company v. Commissioner*, 320 U.S. 516 (1944), the "contested tax" doctrine has developed whereby a tax cannot be accrued (is not accruable) and thus cannot be deducted if a taxpayer disputes his liability therefor. Under these circum-

stances, the taxpayer so contesting must wait until the year the dispute is resolved before the deduction can be legally deemed "accrued."

4. Under our system of taxation, a taxpayer is given the option to take a credit *in lieu* of a deduction for foreign taxes incurred. (See I.R.C. §901(a).) As the district court from which this case is being appealed observed:

"The credit has been characterized as 'an act of grace on the part of Congress,' *Irving Air Chute Co. v. Commissioner of Internal Revenue*, 143 F.2d 256, 259 (2d Cir. 1944), and is available to a taxpayer who meets the conditions of this strictly statutory provision." (Apdx. p. 18a)

5. In the context of this case, it may be helpful to set forth the function of the foreign tax credit in terms of United States taxation policy. Specifically,

"Under the income tax law of the United States, domestic corporations, citizens of the United States wherever resident, and aliens resident in the United States are taxed on world-wide income. Thus, regardless of its geographical source, the entire income of these taxpayers is subjected to the United States income tax. When income is derived from sources outside the United States, it will also usually be taxed in the countries in which it originates. Consequently, the problem of international double taxation arises. There are many possible approaches which a country may take if it wishes to minimize the high rate of taxation caused by the simultaneous imposition of its tax as the country of residence or nationality of the taxpayer and of the tax of another country as the country of source



of the income. While some other devices are used by the United States, it relies primarily upon its unilateral treatment of foreign taxes to relieve the effects of international double taxation of income. Foreign taxes of all types except gift and inheritance taxes are deductible from gross income in computing United States taxable income, just as state taxes are deductible. By far the most important relief, however, is that provided by the foreign tax credit. The foreign tax credit provisions of the income tax law apply only to foreign income taxes, including taxes paid in lieu of income taxes. Under these provisions, domestic corporations, United States citizens, and—on the basis of reciprocity—resident aliens may, at their option, credit rather than deduct foreign income taxes." E. A. Owens, *The Foreign Tax Credit* (1961), p. 2.

6. Over the years, distinctive characteristics of the foreign tax credit mechanism have been manifested in the Code and in administrative practices. In particular, Rev. Rul. 58-55, 1958—1 C.B. 266 involved the application of the "contested tax" doctrine to the foreign tax credit provisions:

"Advice has been requested whether a taxpayer may consider a foreign tax accrued for the purpose of the foreign tax credit if the liability therefor is disputed and cannot be reasonably fixed."

In reaching a decision, the ruling necessarily set forth the conflicting precedents:

"In *Dixie Pine Products Company v. Commissioner*, 320 U.S. 516, Ct. D. 1598, C. B. 1944, 509, the Supreme Court of the United States held that a taxpayer, em-

ploying the accrual method of accounting, could not accrue and deduct the amount of gasoline tax assessed against it by the State taxing authorities, so long as such taxes were contested by the taxpayer; and that the taxpayer may claim a deduction for such tax only for the taxable year in which the liability therefor is finally adjudicated.

"However, in the case of *The Cuba Railroad Company v. United States*, 124 Fed. Supp. 182, the court held, so far as pertinent, that taxes paid to Cuba constituted a proper accrual for the purpose of the foreign tax credit for the year to which they relate irrespective of the fact that such taxes were contested and paid in a later year. Thus, the court rejected the 'contested tax' doctrine in cases involving the accrual of a foreign tax under section 131(d) of the Internal Revenue Code of 1939, now section 905(a) of the Internal Revenue Code of 1954, for the purpose of the foreign tax credit."

After reviewing the history of the foreign tax credit provisions and highlighting their unique nature in the statutory framework, the ruling *held*:

"... the 'contested tax' doctrine as expressed in the *Dixie Pine Products Company* case is not applicable to the accrual of a foreign tax for the purpose of the credit under section 901 of the 1954 Code and section 131 of the 1939 Code."

Had the ruling ended there, one would naturally conclude, following *Cuba Railroad*, that the chief obstacle to a legal accrual had been removed from consideration. That is, since the "contested tax" doctrine is inapplicable, it follows that the tax has accrued.

However, the ruling went on and further stated:

"A foreign tax for the purpose of such credit is accruable for the taxable year to which it relates even though the taxpayer contests the liability therefor and such tax is not paid until a later year. *Such accrual, however, cannot be made until the contested liability is finally determined.*" (Emphasis added)

The italicized portion focuses on the problem at hand and gives rise to an apparent contradiction. Either the foreign tax has accrued or it has not accrued. The ruling identified the year of the accrual consistent with the Congressional philosophy of avoiding a double tax on the income of a particular accounting tax year. So long as the year to which the tax relates back is "open," no administrative difficulty arises in the determination of a taxpayer's claim for adjustment of the tax year in question.

However, in truth, it appears Rev. Rul. 58-55 did not contemplate or address itself to the 10-year statute. Plaintiff-Appellant is asking the Court to correct that oversight and hold that foreign tax disputes need not be finalized within the 10-year statute of limitation period. A foreign tax has "accrued" even though disputed. Plaintiff-Appellant believes such a holding will not distort statutory language or purpose, will do no violence to administrative practice and procedures, and will be in keeping with fair play. Thus, the meaning to be ascribed to "such accrual . . . cannot be made" should not prevent this suit from being maintained if the result thereof aborts *forever*, Plaintiff-Appellant's legal posture vis-a-vis the foreign tax credit.



7. Moreover, it must be stressed that if Plaintiff-Appellant had conceded its liability for the Lebanese tax, *the payment thereof would have unquestionably been a creditable tax*, and Plaintiff would then have recovered the amount of such payment from the U.S. Government. Plaintiff-Appellant chose the course of continuing to contest the tax, and filed its refund claim and this suit within the time prescribed by IRC section 6511(d)(3).

In another context, but nevertheless illustrating the interest of the U.S. Government in the contest of foreign tax liabilities by U.S. taxpayers is the following statement:

"When . . . income is allocated to a domestic corporation from its foreign subsidiary under section 482 of the Code, a presumption arises that the subsidiary has made a contribution to the foreign government. This presumption will be rebutted if the subsidiary *exhausts all effective and practicable administrative remedies in seeking a refund of its foreign income tax liability* and if the domestic parent exhausts its rights under the competent authority procedure . . ." (Emphasis added) (Rev. Rul. 76-508, 1976-2 C.B. 225)

In keeping with the letter and spirit of that mandate, Plaintiff-Appellant is exhausting its remedies abroad.

8. It is well settled, and the administrative position regarding "accruals" is clear, that *absent* the "contested tax" aspect, the Lebanese Government's official Income Tax Assessment for 1962 establishes not only the correct accounting year of such accrual, but also that an *accrual* in fact has occurred.



General Counsel's memorandum 9459 Cum. Bul. X-1 (1931) p. 169 sets forth the appropriate rule:

" . . . Where a foreign tax law is in effect at the end of the taxable year there would be no difficulty in accruing the foreign income tax credit as at the end of the tax year, for the reason that at such time all the events had occurred which fix the amount of the tax and the liability of the taxpayer to pay it. (See *United States v. Anderson*, 269 U.S., 422, T.D. 3839, C.B. V-1, 179.) In this connection it may be stated that the previous decisions of the Bureau pertaining to the proper accrual date of taxes which may be claimed as a deduction from the gross income are in general applicable to the time of accrual of foreign taxes which may be claimed as a credit against the United States taxes. (See S.M. 4499A, C.B. V-1, 56; G.C.M. 6273, C.B. VIII-1, 168; G.C.M. 6272, C.B. VIII-1, 170; G.C.M. 7514, C.B. IX-1, 111; G.C.M. 7190, C.B. VIII-2, 113; I.T. 2495, C.B. VIII-2, 98; G.C.M. 6075, C.B. VIII-1, 76; G.C.M. 8553, C.B. IX-2, 109.) All these decisions follow the rule laid down by the Supreme Court in *United States v. Anderson*, *supra*."

It is submitted, remove the "contested tax" doctrine from this recitation of tax accrual principles, and it is hard to escape the conclusion that an "accrual" of the Lebanese tax assessment in question has occurred.

9. Plaintiff-Appellant's position does not create administrative difficulty or burden the U.S. Government.

(a) I.R.C. section 905(c) provides:

"If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid

is refunded in whole or in part, the taxpayer shall notify the Secretary or his delegate, who shall re-determine the amount of the tax for the year or years affected." (Emphasis added)

This section has remained unchanged since its enactment as part of the Revenue Act of 1918, where it was added by the Conference Managers' Report (65th Cong., 3d Sess., H. Rept. 1037).

This means, and the administrative practice so confirms, that there is *no time bar* preventing the Government from adjusting foreign tax credits taken on tax returns filed by U.S. taxpayers. (See Treas. Reg. section 1.905-3(a), General Counsel's Memorandum 18801, 1937-2 C.B. 302 and Rev. Rul. 73-573, 1973-2 C.B. 290.) The General Counsel's Memorandum *supra* rationalized this statutory provision as follows (p. 304):

"When the amount for which he took credit and which he paid to a foreign country is returned to him (it may be long after such payment), that amount rightfully belongs to the United States. It represents the tax which he reported due to the United States but did not pay to the United States. Such payment was in effect suspended. Clearly, no statute of limitations could within reason be held to be running during such suspension."

Accordingly, if the Plaintiff-Appellant prevails in this suit, and it is eventually determined that the Lebanese tax is not payable, the United States can recover the refund, plus the statutory interest thereon *anytime in the future*.

(b) In addition, I.R.C. section 905(c) further provides:

“ . . . In the case of such a tax *accrued but not paid*, the Secretary, as a condition precedent to the allowance of this credit, may require the taxpayer to give a bond, with sureties satisfactory to and to be approved by the Secretary, in such sum as the Secretary may require, conditioned on the payment by the taxpayer of any amount of tax found due on any such redetermination, and the bond herein prescribed shall contain such further conditions as the Secretary may require.”  
(Emphasis added)

The intent of Congress clearly permits the credit for unpaid taxes to remain in a state of suspense until they are ultimately determined and paid. Aside from demonstrating a practical solution to the Plaintiff-Appellant's dilemma, recognition is explicit to the realities of international taxation that foreign tax “accruals” by U.S. taxpayers can properly be made on U.S. tax returns notwithstanding a possibility or even probability of change, alteration, questionable liability and other problems that may remain associated therewith. *All of this is inherent in the foreign tax credit legislative scheme of things.*

The procedure of posting a bond gives the Government the necessary fiscal protection in light of the Congressional intent that the foreign tax credit provisions prevent double taxation of foreign income. It is submitted, this end will be frustrated if Plaintiff-Appellant does not prevail in this appeal and the Lebanese controversy is resolved unfavorably to Plaintiff-Appellant.

(c) Plaintiff-Appellant has suggested in the proceedings below still another solution to this problem by moving to have this case placed on the Suspense Docket.



(d) The 10-year period prevents stale claims. Plaintiff-Appellant has fulfilled its responsibility by bringing this suit within the 10-year period. The Lebanese income tax assessment has "accrued" for purposes of this statute and the whole fabric of the foreign tax credit provisions in the full legal sense of that term under the circumstances aforementioned.

10. Plaintiff-Appellant respectfully requests the Court to take cognizance of the peculiar position Plaintiff-Appellant is in regarding its dispute with a sovereign power and its inability to obtain a resolution of that dispute short of payment of the tax, which would have given it a clear right to the foreign tax credit. Its unwillingness to thus resolve the matter at the expense of the United States, should not prejudice its case, in the light of the complete safeguard given the Government by I.R.C. section 905(c) in case it is determined that the Plaintiff-Appellant is not liable for the Lebanese tax in question.

### CONCLUSION

For the foregoing reasons, the judgment of the district court should be reversed.

Respectfully submitted,

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